CONFIDENTIAL

The Director of Central Intelligence

Washington, D.C. 20505

NIC #4398-83
17 June 1983

National Intelligence Council

MEMORANDUM FOR: Director of Central Intelligence
Deputy Director of Central Intelligence

FROM: Maurice C. Ernst
NIO for Economics

SUBJECT: NSC Meeting on International Debt Problem

1. This memorandum reviews the international debt issues and the actions being considered by the US Government. It includes material covered in my memo of 8 June, as well as some new material.

2. The purpose of this NSC meeting was to hear a briefing on the international debt problem. [redacted] Chief of the [redacted] Branch in OGI, prepared and presented part of the briefing. His memo on the meeting is attached (Tab A), as is a copy of the briefing (Tab B). 25X1 25X1

3. The Brazilian debt crisis once again is coming to a head. The IMF has found Brazil to be out of compliance with some of its internal economic targets and has withheld disbursements on its credits. If a new agreement is not achieved soon, Brazil will probably have to declare a complete debt service moratorium, which could have dangerous consequences. I wrote an informal contingency memo on the Brazilian situation last week (Tab C).

4. There is progress toward a new Brazilian package.

- o A new, broader bank consortium, including some foreign banks, has been organized to help Brazil.

[redacted] 25X1

- o They may be willing to commit funds for 1984.

CONFIDENTIAL

- o The Federal Reserve will make ESF money available.

- o The BIS may provide more funds.

- o The Brazilians have announced some domestic adjustment measures and there is optimism at Treasury that there will be a new IMF agreement by the end of the month.

Even so, there are risks of mutual miscalculation.

[redacted] 25X1

6. Policy deliberations on the debt problem have led to a general strategy of dealing with liquidity crises on an ad hoc basis, hoping that economic recovery will take care of the problem in the longer term. As I see it, there are four potential weak points in the strategy:

- o Ad hoc short-term solutions may require substantially more funding and it is not clear where the money will come from. In addition to Brazil, Nigeria, Venezuela, perhaps Mexico, and other countries will need large additional funding in 1983, and nearly all the big debtors will need new funds for 1984. Most of the new credits are coming from the large US banks and are essentially involuntary. The liquidity problem is greatly worsened by a general lack of market confidence, withdrawals of interbank deposits by smaller banks and many large foreign banks, a contraction of trade credit, and other forms of capital flight. Attached is a brief review by [redacted] one of our NIC consultants (Tab D). 25X1

- o A related problem for the current strategy is the inflexibility created by the many debt refinancing agreements involving the IMF, the banks, and the debtor countries. The IMF understandably is very concerned about its credibility. It does not want to establish bad precedents by bowing to borrowers' pressure, but this can lead to potentially dangerous confrontations.

- o The debt situation should improve in the next two or three years as world economic recovery proceeds. If recovery is not sustained, radical solutions will probably be needed. Even if it is sustained, however, several of the largest debtors, notably Brazil, Mexico, Argentina, and Venezuela, will face extremely difficult structural adjustments and depressed per capita incomes. There is a substantial risk that the political reaction to forced, prolonged austerity will become stronger and better organized even after the worst part of the economic crisis is over. We will be examining this medium-term problem in a National Intelligence Estimate tentatively scheduled for October.

- In the longer term there will be a need not only for large economic adjustments in the LDCs, but also for instruments to encourage continued large net flows of capital to the LDCs. Smaller banks are unlikely to resume substantial lending to LDCs any time soon. It may take several years of improved economic conditions for even the larger banks to resume large scale voluntary net lending to LDCs, as distinct from the current involuntary lending, the purpose of which is simply to protect existing exposure. It would be highly desirable for direct private foreign investment in LDCs to increase rapidly, not only to fill a financial gap, but also to provide a more flexible, purposeful and long-term means of supporting economic development. But there is a high risk that the policy reactions to prolonged austerity in LDCs will discourage rather than encourage foreign direct investment. The latest Morgan Guaranty monthly provides an excellent analysis of these issues (Tab E).

Maurice C. Ernst

Attachments:
As stated

NIC #4398-83
17 June 1983

SUBJECT: NSC Meeting on International Debt Problem

DCI/NIC/NIO/Econ:M.Ernst:bha(16 June 1983) [redacted] 25X1

Dist:
Orig - DCI
1 - DDCI
1 - ExDir
1 - DCI/SA/IA
1 - ER
1 - DDI Registry
1 - C/NIC
1 - VC/NIC (H.M.)
1 - VC/NIC (C.W.)
2 - NIO/Econ
1 - DDI
1 - D/OGI
[redacted] 25X1